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No. 59

In the Supreme Court of the United States

OCTOBER TERM, 1929

MABEL G. REINECKE, COLLECTOR OF INTERNAL REVENUE FOR THE FIRST DISTRICT OF ILLINOIS, PETITIONER

v.

EUDORA HULL SPALDING

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF FOR THE PETITIONER

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OPINIONS BELOW

The District Court did not write an opinion. Its reasons for directing a verdict in favor of the respondent appear on page 44 of the Record. The opinion of the Circuit Court of Appeals (R. 159) is reported in 30 F. (2d) 369.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on January 2, 1929. (R. 159.) Petition for certiorari was filed March 30, 1929. Certiorari was granted April 29, 1929. (R. 165.)

The jurisdiction of this Court rests on Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

The question in this case is whether in computing income taxes for 1917 and 1918 a taxpayer who received royalties under leases of mining lands made prior to March 1, 1913, may compute an allowance for the depletion of her interests in mines on the basis of the March 1, 1913, value in the ground of the specific ore extracted during the years for which the computation is made, wholly disregarding the March 1, 1913, value of the taxpayer's interests in the mines and the relation between that value and the total reserves.

STATUTES AND REGULATIONS INVOLVED

The statutes and regulations involved are included in an appendix to this brief, pp. 24–34, *infra*.

STATEMENT

The taxpayer is the owner of an undivided one-sixth interest in certain lands underlaid with iron ore, which prior to March 1, 1913, she and her co-owners had leased to various lessees for the purpose of extracting or mining, taking out, and removing and shipping therefrom the merchantable ore upon royalties at the rate of twenty-five cents per ton. (R. 63, 75, 83, 92, 100, 108, 116.) Under these leases the taxpayer received as royalties the sum of $260,072.30 during the year 1917, and the sum of

$219,940.43 during the year 1918. (R. 22.) In her income-tax return for those years she reported the amounts so received as income and deducted as reasonable allowances for depletion the same amounts, thus reporting as taxable income from rents and royalties "none." (Plaintiff's Exhibits A and B, R. 46, 54.) Upon the filing of these returns the Commissioner notified the taxpayer (R. 128):

> Your method of deducting from gross income the entire amount received as royalty from iron mines as depletion is not approved by this office. The correct amount to be deducted for depletion, based upon the unit cost per ton of mineral reserves, as of March 1, 1913, as determined by the Valuation Engineers of this Department is shown as follows: * * *
>
> For 1917 ..... $92,194.92 (R. 128)
> and for 1918 ..... 77,968.20 (R. 141)

Later, upon reconsideration, the Commissioner increased the depletion for 1917 to $99,561.20 (R. 139), and for 1918 to $84,979.55 (R. 143).

The taxpayer paid under protest the additional taxes assessed by reason of the changes made in the depletion allowances and filed claims for refund. Her claim for the year 1917 alleges that the additional tax is erroneous because (R. 145)—

> Tax as assessed is based upon income received from royalties from iron ore mines. Depletion amounting to $99,561.20 was allowed to taxpayer, whereas depletion amounting to $203,510.86 should be allowed.

> The latter amount is the present worth of the ore mined in 1917, as of March 1, 1913, and is arrived at by discounting the amount received in 1917 at 5% to March 1, 1913.

The claim for 1918 was predicated upon the same alleged error. (R. 148.) Both of these claims were rejected (R. 149, 150), whereupon the taxpayer brought this action in the United States District Court for the Northern District of Illinois.

The record does not clearly show the method used by the Commissioner in computing the allowances, but the taxpayer's method does clearly appear.

The Government contended in the courts below that the method used by the taxpayer is improper and that the proper allowance for depletion in each year in respect to each mine must, in accordance with the statutes and regulations, be determined by taking as a basis the March 1, 1913, value of the taxpayer's interest in that mine. The Government further contended that this value should be multiplied by the percentage of the whole reserve which was withdrawn and paid for during the year for which the allowance is computed, and that therefore the proper allowance could not be computed unless the March 1, 1913, value of the taxpayer's interest in the mines and the reserve tonnage were shown, and, that as the taxpayer failed to show these factors, she could not recover. (R. 17, 154.)

The case was tried in the District Court before a jury. At the close of the evidence the Government

moved for a directed verdict (R. 17) on the ground there was not sufficient evidence to entitle the taxpayer to recover and that the verdict must be for the Government because—

1. There is no legally sufficient evidence to show the fair market value as of March 1, 1913, of the plaintiff's interest in each of the mines involved in this action.

2. There is no legally sufficient evidence to show the tonnage known or estimated remaining in the respective mines as of December 31, 1916, December 31, 1917, December 31, 1918, and December 31, 1919, respectively.

3. The undisputed evidence shows that the method for calculating depletion allowance used by the plaintiff does not result in reasonable allowance.

4. The undisputed evidence shows that the method of calculating depletion allowance used by the plaintiff is not in compliance with the regulations of the Commission of Internal Revenue duly promulgated.

5. The undisputed evidence shows that the allowances computed by the plaintiff are not a percentage of his capital invested equal to the percentage of the whole mineral content withdrawn during the year, and are not a percentage of his capital investment equal to the percentage of the unpaid royalties paid during the year for which the calculation is made.

The taxpayer also moved for a directed verdict. (R. 18.) The court granted the taxpayer's motion and denied the Government's motion. (R. 44.) To these rulings exceptions were duly taken and an appeal to the Circuit Court of Appeals for the Seventh Circuit was prosecuted. The errors assigned in that court are found on pages 154–155 of the Record.

That court affirmed the judgment of the District Court. (R. 163.) It held that the proper allowance for depletion was the market value on March 1, 1913, of the tonnage in the mine of the product mined during the year for which the return is made, "less the interest carrying charge of 5%" and that since the plaintiff had established that market value and this charge, she was entitled to the deduction claimed by her in her amended declaration. (R. 163.) The opinion says (R. 160):

> The sole controversy is over the correctness of the Government's method of arriving at the value of the iron ore in the ground on March 1, 1913, a matter not covered by the revenue acts in question, nor by any regulation of the Treasury Department.

We contend that these premises are incorrect. The opinion of the court also makes certain statements as to the Government's methods which, we submit, are not supported either by the record or by the facts. (See pp. 34–38, *infra*.)

SPECIFICATION OF ERROR TO BE URGED

The Circuit Court of Appeals erred in holding that the taxpayer was entitled under Section 214 (a) (10) of the Revenue Act of 1918 and under Section 5 (a) Eighth of the Revenue Act of 1916 to compute the reasonable allowance for depletion upon the basis of the fair cash market value in the mine of the tonnage mined during the taxable year, and to deduct this value less the "interest carrying charge," said to be five per cent per annum from March 1, 1913. (R. 163.)

SUMMARY OF ARGUMENT

1. The taxpayer had the burden of establishing the facts showing that she was entitled to the allowance for depletion which the Commissioner had disallowed.

2. The taxpayer failed to establish the value of her interest in the mines as of March 1, 1913. Although several witnesses testified that the value of the ore in place in the mines was 25 cents per ton on March 1, 1913, every one of these witnesses admitted that the question as to the value of the taxpayer's interest in the ore was an entirely different matter and no witness testified as to this matter. Nevertheless, the court below proceeded upon the theory that her interest on March 1, 1913, in the ore was valued at the rate of 25 cents per ton.

3. The only proper basis for computing the allowance for depletion was the value of the taxpayer's interest in the mines on March 1, 1913.

The taxpayer's only interest in the properties on March 1, 1913, was that of lessor. The Revenue Acts of 1917 and 1918 and the regulations made in pursuance of the authority granted by them provide in effect that the basis for computing the allowance for depletion in the case of a lessor of mining properties is the value as of March 1, 1913, of the royalties to be expected under the terms of the lease in effect on that date, and that the allowance must represent the reduction of capital assets of the taxpayer during the year. The regulations are based upon correct principles and have the force and effect of law.

4. The allowance for depletion should be computed by determining the percentage of the whole reserve which was withdrawn and paid for during the taxable year and taking this same percentage of the value of the taxpayer's interest in the mine on March 1, 1913. This is required by correct principles of depletion and the specific provisions of the regulations. It is also in accordance with the customary practice in the mining industry, according to the uncontradicted testimony in this case. The courts below, however, followed a method which was not based upon the March 1, 1913, value of the taxpayer's interest in the property and a method which results in a depletion allowance having no necessary relation to that percentage.

ARGUMENT

I

THE TAXPAYER HAD THE BURDEN OF ESTABLISHING THE FACTS SHOWING THAT SHE WAS ENTITLED TO THE ALLOWANCE FOR DEPLETION WHICH THE COMMISSIONER HAD DISALLOWED

This burden rests upon the taxpayer in an action brought by him to recover taxes alleged to have been illegally collected. In *Botany Mills* v. *United States,* 278 U. S. 282, such an action was brought by a taxpayer which was a corporation. It contended that in the computation of its income taxes it was entitled to a large deduction on account of certain payments made to its directors, on the ground that these payments constituted a part of its "ordinary and necessary expenses" in the maintenance and operation of its business and property. This Court said (pp. 289–290):

> And in this suit the burden of establishing that fact rested upon it, in order to show that it was entitled to the deduction which the Commissioner had disallowed, and that the additional tax was to that extent illegally assessed.

See also, to the same effect, *United States* v. *Anderson,* 269 U. S. 422, 443.

II

THE TAXPAYER FAILED TO ESTABLISH THE VALUE OF HER INTEREST IN THE MINES AS OF MARCH 1, 1913

If, as we contend, the only proper basis for computing the allowance for depletion was the value

of the *taxpayer's interest* in the mines as of March 1, 1913, the plaintiff must be denied recovery, as she failed to show that value. Although she put on the stand various witnesses who testified that the March 1, 1913, *value of the ore* in place in the mines was twenty-five cents a ton, every one of these witnesses admitted that the question as to the value of the *taxpayer's interest* in each ton of ore was an entirely different matter, and no witness testified as to this matter. Thus the following appears in the testimony of Savage (R. 24):

> Q. You do not mean by that that Mrs. Spalding's interest in that ton of ore was worth at least 25 cents, do you?
>
> * * * * *
>
> A. That question is based upon Mrs. Spalding's one-sixth ownership of a lease at 25 cents per ton. That question is an entirely different one from the one asked me by Mr. Zane. It would require a good deal of calculation and certain assumptions as to how fast that ore would be shipped. Then it would require discounting against those assumptions to present value. That calculation would take time, and I can not answer that without working it out.

And the witness Keith testified (R. 26):

> Mrs. Spalding's interest in a ton of ore was not necessarily as of March 1, 1913, of the fair market value of over 25c. a ton. In testifying as to the value of a ton of ore I was not speaking of Mrs. Spalding's inter-

> est, or of any one's interest. I was speaking of the value of a ton of ore regardless of ownership. I do not know of my own knowledge what Mrs. Spalding's interest *of* a ton of ore was as of March 1, 1913.

Ives, the third and last witness on the question of value, testified (R. 28):

> I do not know what the value of Mrs. Spalding's interest in any ton of ore would be.

The Circuit Court of Appeals proceeded upon the theory that the taxpayer's interest on March 1, 1913, in the ore was valued at the rate of 25 cents per ton. With respect to this the court said (R. 163):

> It seems clear that the ore mined in 1916 [1917] was worth to plaintiff 25 cents per ton, that that price continued [contained] two elements, mine depletion and profit, and that the way of arriving at the profit was to take the fair cash market value on March 1, 1913, of the tonnage mined in 1916 [1917] (which was shown to be 25 cents per ton) less the interest carrying charge of 5% from March 1, 1913, to 1916 [1917].

This conclusion was based upon the evidence that the ore at all times on and after March 1, 1913, had a market value in the ground untouched and unextracted above 25 cents per ton. (R. 23, 25, 26, 27.) This testimony, however, had no relation to the taxpayer's interest or to any distinct interest.

III

THE ONLY PROPER BASIS FOR COMPUTING THE ALLOWANCE FOR DEPLETION WAS THE VALUE OF THE TAXPAYER'S INTEREST IN THE MINES AS OF MARCH 1, 1913.

On March 1, 1913, the taxpayer did not have the right to extract any ore from any of the mines. Her interest in the properties was merely that of lessor; her rights were merely to receive the royalties stipulated in the leases and to obtain possession of the property on the termination of the leases.

The Revenue Act of 1916 (pp. 24–25, *infra*) allowed a taxpayer deriving income from mines—

> a reasonable allowance for depletion thereof not to exceed the market value in the mine of the product thereof, which has been mined and sold during the year for which the return and computation are made, such reasonable allowance to be made * * * under rules and regulations to be prescribed by the Secretary of the Treasury: *Provided,* That when the allowances authorized * * * shall equal the capital originally invested, or in case of purchase prior to March first, nineteen hundred and thirteen, the fair market value as of that date, no further allowance shall be made.

The Revenue Act of 1918 (pp. 25–26, *infra*) allowed such a taxpayer—

> a reasonable allowance for depletion * * * according to the peculiar conditions in each case, based upon cost including cost of devel-

> opment not otherwise deducted: *Provided,* That in the case of such properties acquired prior to March 1, 1913, the fair market value of the property (or the taxpayer's interest therein) on that date shall be taken in lieu of cost up to that date: * * * such reasonable allowance in all the above cases to be made under rules and regulations to be prescribed by the Commissioner with the approval of the Secretary. In the case of leases the deductions allowed by this paragraph shall be equitably apportioned between the lessor and lessee.

There is nothing in either of these statutes indicating that a lessor of mines could base an allowance for depletion on anything except his own interest in the property (as distinguished from all of the interests in the property). The 1918 Act prescribes as the basis for computing the allowance *the taxpayer's interest* in the property, and we submit that it is not reasonable to construe the 1916 Act in any other way.

The method of computing the allowance adopted by the taxpayer in the instant case finds no support in the regulations governing the collection of the tax for 1917 (pp. 32–34, *infra*), but these indicate that the basis for allowance is the capital interest of the taxpayer in the property on March 1, 1913. The regulations under the 1918 Act (pp. 26–32, *infra*) contemplate that the basis for computing the allowance in the case of a lessor is "the *value of his*

equity in the property at the basic date," and provide that—

> The value of a lessor's equity in a mineral property under lease March 1, 1913, for the entire operating life of the mineral deposits is the value as of March 1, 1913, of the royalties and other payments to be expected under the terms of the lease in effect on that date.

Obviously the value of such an equity would not be the aggregate sum of all of the royalties to be collected over a long term of years, but would be the market value on March 1, 1913, of the lessor's right to the royalties. Article 206 of the regulations under the 1918 Act provides (p. 28, *infra*) that the value which is the basis for depreciation must be determined—

> in the light of the conditions and circumstances known at that date [March 1, 1913] * * *. The value sought should be that established assuming a transfer between a willing seller and a willing buyer as of that particular date.

That this method of determining value is a correct one is demonstrated by the opinion of this Court in *Ithaca Trust Co.* v. *United States,* 279 U. S. 151, 155.

Although the provisions of, and the regulations under, the earlier Act are not as specific as the provisions of, and the regulations under, the Act of 1918, it seems clear that the depletion allowance under the earlier Act and regulations should be

based upon the March 1, 1913, value of the plaintiff's interests. See *United States* v. *Ludey*, 274 U. S. 295; *New Creek Co.* v. *Lederer*, 295 Fed. 433 (certiorari denied 265 U. S. 581). In *Lynch* v. *Alworth-Stephens Co.*, 267 U. S. 364, this Court held that a lessee of a mine was entitled to an allowance for depletion in its income tax for the year 1917, and said (pp. 369, 371):

> The interest of respondent under its leases in the mines being property, its right to deduct a reasonable allowance for exhaustion of such property, if there be any, during the taxable year results from the plain terms of the statute, such deduction, since the property is an interest in mines, to be limited to the amount of the exhaustion of *respondent's interest* caused by the depletion of the mines during the taxable year. * * * The deduction for depletion in the case of mines is a special application of the general rule of the statute allowing a deduction for exhaustion of property. While respondent does not own the ore deposits, its right to mine and remove the ore and reduce it to possession and ownership is property within the meaning of the general provision. Obviously, as the process goes on, this property interest of the lessee in the mines is lessened from year to year, as the owner's property interest in the same mines is likewise lessened. There is an exhaustion of property in the one case as in the other; and the extent of it, with the consequent de-

> duction to be made, in each case is to be arrived at in the same way, namely, by determining the aggregate amount of the depletion of the mines in which the several interests inhere, based upon the market value of the product, *and allocating that amount in proportion to the interest of each severally considered.* (Italics ours.)

The allowance must represent the reduction of capital assets of the taxpayer during the year. See regulations, Articles 201, 172, pp. 26–27, 32, *infra*. This, we submit, is the principle underlying the decision in *United States* v. *Ludey, supra,* in which the Court said (274 U. S. at p. 302):

> The depletion charge permitted as a deduction from the gross income in determining the taxable income of mines for any year represents the reduction in the mineral contents of the reserves from which the product is taken. The reserves are recognized as wasting assets. The depletion effected by operation is likened to the using up of raw material in making the product of a manufacturing establishment. As the cost of the raw material must be deducted from the gross income before the net income can be determined, so the estimated cost of the part of the reserve used up is allowed. The fact that the reserve is hidden from sight presents difficulties in making an estimate of the amount of the deposits. The actual quantity can rarely be measured. It must be approximated. And because the quantity originally in the reserve is not actually

known, the percentage of the whole withdrawn in any year, and hence the appropriate depletion charge, is necessarily a rough estimate. But Congress concluded, in the light of experience, that it was better to act upon a rough estimate than to ignore the fact of depletion.

See also *Weiss* v. *Weiner*, 279 U. S. 333.

The *Ludey case* and the *New Creek Co. case, supra*, also show that the regulations in question are based upon correct principles. These regulations were promulgated, not as an interpretation of the law, but as a complement to it under express authority granted by the Revenue Acts, and hence have the force and effect of law. Regulations so adopted should not be disregarded or departed from unless plainly inconsistent with law. *Boske* v. *Comingore*, 177 U. S. 459; *United States* v. *Birdsall*, 233 U. S. 223; *United States* v. *Morehead*, 243 U. S. 607.

It is well established that only such deductions for depletion as are authorized by statute may be permitted. *Stanton* v. *Baltic Mining Co.*, 240 U. S. 103.

IV

THE ALLOWANCE FOR DEPLETION SHOULD BE COMPUTED BY DETERMINING THE PERCENTAGE OF THE WHOLE RESERVE WHICH WAS WITHDRAWN AND PAID FOR DURING THE TAXABLE YEAR AND TAKING THIS SAME PERCENTAGE OF THE VALUE OF THE TAXPAYER'S INTEREST IN THE MINE ON MARCH 1, 1913

Much of the criticism directed by the Circuit Court of Appeals at the Commissioner's determina-

tion was based upon an erroneous conception of what was actually done. See pp. 34–38, *infra*.

At the trial the Government took the position that the method used by the Commissioner was immaterial (R. 30) and the record does not show exactly how the computation was made. The District Court said that it was conceded at the argument that the record in the case "is for all purposes of this motion, the same record, or, rather, substantially the same record as the record" in *McHale* v. *Hull*. (R. 44.) The Circuit Court of Appeals stated that "The leases, for iron ore bearing lands, in this case, were involved in *McHale* v. *Hull*, 16 Fed. (2d) 781, and were made by appellee in that case and by plaintiff (appellee) here, and others, as lessors." (R. 159.)

Extracts from the agreed statement of facts in *McHale* v. *Hull*, showing how the depletion allowances were computed, appear in Appendix C at the end of this brief.

If, as we have contended above, the burden was upon the taxpayer to show that she was entitled to the allowance for depletion which the Commissioner had disallowed, the position taken by the Government in the court below was correct, and for purposes of the decision of the instant case it would seem unnecessary to discuss the correct theory. Nevertheless, it appears to us pertinent to point out the correct method and to demonstrate that the principles adopted by the court below were at variance with this method.

The deductions allowed on account of the depletion of mines are intended to return to the taxpayer his capital invested in the mines. *United States* v. *Ludey*, 274 U. S. 295, *supra*; *Weiss* v. *Weiner*, 279 U. S. 333, *supra*. As this Court said in *Stratton's Independence* v. *Howbert*, 231 U. S. 399, 421, the amount of depreciation is to be "determined not upon the basis of latent and occult intrinsic values, but upon considerations that affect market value and have their influence upon men of affairs charged with the management of the business and accounting of corporations that are organized for profit and are engaged in business for purposes of profit."

The capital investment should be returned in step with the exhaustion of the physical property, that is to say, the depletion allowed with respect to each ton of ore mined and sold should be the same proportion of the capital invested as that ton is of the total reserves in which that capital is invested. See *United States* v. *Ludey*, 274 U. S. 295 (pp. 16–17, *supra*).

In order to apply the principles just stated, it is necessary to obtain the value on March 1, 1913, of the taxpayer's expected royalties. To value these, resort should be had to a discount factor in accordance with the sinking fund method for valuing equal amounts of annual income. If the reversion is valuable, the value of this should be included, but if it is contemplated that the whole value of the land will be exhausted during the leases, nothing need be

added for this interest. When the entire value of the taxpayer's interest has been ascertained, the value of the taxpayer's interest in a single unit comprised within the ore deposit should be determined in accordance with the regulations by dividing the value of the whole by the number of units. The quotient thus obtained represents the amount of capital applicable to each unit. When multiplied by the number of units extracted in any one year, the product will be the amount which will constitute an allowable deduction from the gross income of that year on account of depletion. Article 210, p. 32, *infra;* Article 172, p. 33, *infra.*

The method thus provides for the return of the capital investment in step with the exhaustion of the ore bodies. The calculation results in a depletion figure which, when deducted from the total royalties received during the year, shows the amount of taxable profit over the original capital.

The taxpayer in this case did not show, and does not seem to contend, that the Commissioner did not compute the depletion according to this method.

There was uncontradicted testimony of a qualified consulting mining engineer that in figuring depletion in the mining industry, it is the custom to take the value of the owner's interest in the mine on the basic date, to divide that value by the tonnage to get a factor to be used for depletion, and to figure the depletion for any year by multiplying that factor by the number of tons extracted in that year; and that without the value of the owner's interest on

the basic date and an estimate of the ore reserve it is impossible to determine a proper allowance for depletion. (R. 40–41.) The same witness also testified, without contradiction, that the unit of depletion depends upon the proportion of the total reserve in the mine which is extracted during the year. (R. 41–42.) All of this testimony the courts below disregarded.

The Circuit Court of Appeals assumed that respondent owned the ore in place on March 1, 1913, and held that its intrinsic value, determined by reference to events occurring thereafter and consequently unknown on March 1, 1913, was her capital and that she is entitled to deduct that value as the measure of depletion This method entirely disregards the extent of the mineral reserve on March 1, 1913, and gives no weight to the portion of the reserve which was exhausted in each taxable year. It permits an allowance which may result in the return of the taxpayer's entire capital prior to the exhaustion of the mine, or it may result in her never receiving tax-free her whole capital investment. Only through a coincidence can it result in her receiving back the last of her capital simultaneously with the exhaustion of the last of the ore. This is so because this method depends wholly upon the element of time and attributes to a ton of ore mined in one year a greater capital value than it attributes to a ton mined in a subsequent year. This is erroneous because a ton mined in 1917 is the same proportion of the total tonnage in the mine on

March 1, 1913, as is another ton of ore mined in 1918.

Several mines were involved, and yet the Circuit Court of Appeals applied a common rate of depletion to each. In *United States* v. *Ludey*, 274 U. S. 295, *supra*, this Court indicated the necessity of a separate rate for each property. It was there said (p. 304):

> The deduction allowable in the several years for each of the properties is not found.

It can not be that each mine contained the same amount of mineral ore and that each mine suffered annual exhaustion in the same proportion. If these factors are to be disregarded, as the Circuit Court of Appeals indicated, then the term "depletion" becomes a misnomer.

If the taxpayer's interest in each ton of ore on March 1, 1913, was 25 cents, and if she received 25 cents for it in the taxable years, it is not clear upon what basis the Circuit Court of Appeals applied a 5% interest rate to determine the depletion. If she had a capital investment of 25 cents in each ton of ore she should logically demand a deduction in the same amount on account of depletion, thus disregarding any element of profit. Without some clear reason for applying a 5% interest rate, the method adopted in this case seems to require a depletion allowance similar to that which this Court has already characterized as quite inadmissable. *Stratton's Independence* v. *Howbert*, 231 U. S. 399, *supra*.

From the foregoing it appears that the Circuit Court of Appeals has approved a method of depletion which is not based upon the March 1, 1913, value of respondent's interest in the whole mineral reserve and a method which results in a depletion allowance having no necessary relation to the exhaustion of her interest. We submit that the statutes, regulations, and opinions of this Court require that these factors be taken into account.

Discussion of some subsidiary matters as to which we contend the court below was mistaken is inserted in Appendix B, pp. 34–38, *infra*.

CONCLUSION

For the reasons stated, we respectfully submit that the judgment of the court below should be reversed.

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NOVEMBER, 1929.

APPENDIX A

STATUTES AND REGULATIONS

As this action is brought to recover taxes for two years, the provisions of two Acts are involved. Taxes for the year 1917 are to be computed under the Revenue Act of 1917, c. 63, 40 Stat. 300, and the Revenue Act of 1916, c. 463, 39 Stat. 756, and specifically under Section 5 (a) thereof, which reads, so far as material, as follows (p. 759):

> Sec. 5. That in computing net income in the case of a citizen or resident of the United States—
>
> (a) For the purpose of the tax there shall be allowed as deductions—
>
> * * * * *
>
> Eighth. (a) In the case of oil and gas wells a reasonable allowance for actual reduction in flow and production to be ascertained not by the flush flow, but by the settled production or regular flow; (b) in the case of mines a reasonable allowance for depletion thereof not to exceed the market value in the mine of the product thereof, which has been mined and sold during the year for which the return and computation are made, such reasonable allowance to be made in the case of both (a) and (b) under rules and regulations to be prescribed by the Secretary of the Treasury: *Provided,* That when the allow-

ances authorized in (a) and (b) shall equal the capital originally invested, or in case of purchase made prior to March first, nineteen hundred and thirteen, the fair market value as of that date, no further allowance shall be made. No deduction shall be allowed for any amount paid out for new buildings, permanent improvements, or betterments, made to increase the value of any property or estate, and no deduction shall be made for any amount of expense of restoring property or making good the exhaustion thereof for which an allowance is or has been made.

Taxes for the year 1918 are controlled by the Revenue Act of 1918 (c. 18, 40 Stat. 1057, 1066, 1067), which provides in part as follows:

SEC. 214. (a) That in computing net income there shall be allowed as deductions:

* * * * *

(10) In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case, based upon cost including cost of development not otherwise deducted: *Provided,* That in the case of such properties acquired prior to March 1, 1913, the fair market value of the property (or the taxpayer's interest therein) on that date shall be taken in lieu of cost up to that date: *Provided further,* That in the case of mines, oil and gas wells, discovered by the taxpayer, on or after March 1,

1913, and not acquired as the result of purchase of a proven tract or lease, where the fair market value of the property is materially disproportionate to the cost, the depletion allowance shall be based upon the fair market value of the property at the date of the discovery, or within thirty days thereafter; such reasonable allowance in all the above cases to be made under rules and regulations to be prescribed by the Commissioner with the approval of the Secretary. In the case of leases the deductions allowed by this paragraph shall be equitably apportioned between the lessor and lessee.

Complying with the provisions of the statutes the following regulations were made:

Regulations 45 (1920 ed.) relating to the income tax under the Revenue Act of 1918.

ART. 201. *Depletion of mines, oil and gas wells; depreciation of improvements.*—Sections 214 (a) (10) and 234 (a) (9) provide that taxpayers shall be allowed as a deduction in computing net income in the case of natural deposits a reasonable allowance for depletion of mineral and for depreciation of improvements. The provisions of the statute and these articles do not apply to or affect the regulations covering invested capital, losses, accounting methods, etc.

The essence of these provisions of the statute is that the owner of mineral deposits, whether freehold or leasehold, shall within the limitations prescribed, secure through an

aggregate of annual depletion and depreciation deductions the return of either (a) his capital invested in the property, or (b) the value of his property on the basic date, plus subsequent allowable capital additions (see article 222), but not including land values for purposes other than the extraction of minerals.

Operating owners, lessors, and lessees, whether corporations or individuals, are entitled to deduct an allowance for depletion and depreciation * * *.

ART. 204. *Capital recoverable through depletion in case of lessor.*—(a) In the case of a lessor, the capital remaining in any year recoverable through depletion and depreciation deductions is (1) the value of his equity in the property at the basic date minus (2) depletion and depreciation sustained, whether legally allowable or not, from the basic date to the taxable year, plus (3) subsequent allowable capital additions, and minus (4) the value of the land at the basic date for other purposes than mineral production. The capital recoverable through depletion is the total capital remaining less the sum recoverable through depreciation.

(b) The value of the equities of lessor and lessee shall be computed separately, but, when determined as of the same basic date, shall together never exceed the value at that date of the property in fee simple.

* * * * *

(d) The value of a lessor's equity in a mineral property under lease March 1, 1913, for the entire operating life of the mineral

deposits is the value as of March 1, 1913, of the royalties and other payments to be expected under the terms of the lease in effect on that date.

(e) The value of a lessor's equity in a mineral property under lease for a portion of its operating life is the value as of March 1, 1913, of the royalties expected from the mineral to be extracted during the life of the existing lease plus the estimated en bloc value of the mineral remaining at its expiration, which, in the absence of satisfactory evidence to the contrary, will be presumed not to exceed the value as of March 1, 1913, of royalties which could have been expected as at that date from the remaining mineral.

ART. 206. *Determination of fair market value of mineral property.*—(a) Where the fair market value of the property at a specified date in lieu of the cost thereof is the basis for depletion and depreciation deductions, such value must be determined, subject to approval or revision by the Commissioner, by the owner of the property in the light of the conditions and circumstances known at that date, regardless of later discoveries or developments in the property or subsequent improvements in methods of extraction and treatment of the mineral product. The value sought should be that established assuming a transfer between a willing seller and a willing buyer as of that particular date. The Commissioner will lend due weight and consideration to any and all factors and evidence having a bearing on the

market value, such as cost, actual sales and transfers of similar properties, market value of stock or shares, royalties and rentals, value fixed by the owner for purpose of the capital-stock tax, valuation for local or State taxation, partnership accountings, records of litigation in which the value of the property was in question, the amount at which the property may have been inventoried in probate court, disinterested appraisals by approved methods such as the present value method and other factors.

(b) To determine the fair market value of a mineral property by the present value method, the essential factors must be determined for each deposit included in the property. The factors are (1) the total quantity of mineral in terms of the principal or customary unit (or units) paid for in the product marketed, (2) the average quality or grade of the mineral reserves, (3) the expected percentage of extraction or recovery in each process or operation necessary for the preparation of the crude mineral for market, (4) the probable operating life of the deposit in years, (5) the unit operating cost, i. e., cost of production exclusive of depreciation and depletion, (6) expected average selling price per unit during the operating life, and (7) the rate of profit commensurate with the risk for the particular deposit. When the deposit has been sufficiently developed these factors may be determined from past operating experience.

In the application of factors derived from past experience full allowance should be made for probable future variations in the rate of exhaustion, quality or grade of the mineral, percentage of recovery, costs of production, and selling price of the product marketed during the expected operating life of the mineral deposit.

* * * * *

(c) Mineral deposits for which these factors may not be determined with reasonable accuracy from past operating experience may, with the approval of the Commissioner, be valued in a similar manner; but the factors must be deduced from concurrent evidence such as the general type of the deposit, the characteristics of the district in which it occurs, the habit of the mineral deposits in the property itself, the intensity of mineralization, the rate at which additional mineral has been disclosed by exploitation, the stage of the operating life of the property, and other evidence tending to establish a reasonable estimate of the required factors.

(d) Mineral deposits of different grades, locations, and probable dates of extraction in a mineral property shall be valued separately. The mineral content of a deposit should be determined in accordance with article 208 in the case of mines, with article 209 in the case of oil wells, and with articles 211 and 212 in the case of gas wells. In estimating the average grade of the developed and prospective mineral, account should be taken of probable increases or decreases as

indicated by the operating history. The rate of exhaustion of a mineral deposit should be determined with due regard to the limitations imposed by plant capacity, by the character of the deposit, by the ability to market the mineral product, by labor conditions, and by the operating program in force or definitely adopted at the basic date for future operations. The operating life of a mineral deposit is that number of years necessary for the exhaustion of both the developed and prospective mineral content at the rate determined as above. The operating cost comprises all current expense of producing, preparing, and marketing the mineral product sold, exclusive of Federal income, war profits, and excess profits taxes, allowable capital additions as defined in article 222, and deductions for depreciation and depletion, but including cost of repairs and replacements necessary to maintain the plant and equipment at its rated capacity and efficiency. This cost of repairs and replacements is not to be confused with the depreciation deduction by which the cost or value of plant and equipment is returned to the taxpayer free from tax. In general no estimates of these factors will be approved by the Commissioner which are not supported by the operating experience of the property or which are derived from different and arbitrarily selected periods.

(e) The product of the number of units of mineral recoverable in marketable form by the difference between the selling price

and the operating cost per unit is the total expected operating profit. The value of each mineral deposit is then the total expected operating profit from that deposit reduced to a present value as of the basic date at the rate of interest commensurate with the risk for the operating life, and further reduced by the value at the basic date of the depreciable assets and of the capital additions, if any, necessary to realize the profits.

ART. 210. * * *

(b) When the value of the property at the basic date has been determined, depletion for the taxable year shall be determined by dividing the value remaining for depletion by the number of units of mineral to which this value is applicable, and by multiplying the unit value for depletion, so determined, by the number of units sold within the taxable year. In the selection of a unit for depletion preference shall be given to the principal or customary unit or units paid for in the product sold.

Regulations 33 (Revised) governing the collection of the income tax imposed by the Act of September 8, 1916:

ART. 172. If the property was acquired by purchase or otherwise (other than by lease) prior to March 1, 1913, the amount of invested capital which may be extinguished through annual depletion deductions from gross income will be the fair market value of the mine property so acquired, as of March 1, 1913. The value contemplated herein as the basis for depletion deductions authorized

by this title must not be based upon the assumed salable value of the output under current operative conditions, less cost of production, for the reason that the value so determined would comprehend the profits to be realized from operation of the property.

Neither must the value determined as of March 1, 1913, be speculative, but must be determined upon the basis of the salable value *en bloc* as of that date of the entire deposit of minerals contained in the property owned, exclusive of the improvements and development work; that is, the price at which the natural deposits or mineral property as an entirety in its then condition could have been disposed of for cash or its equivalent.

The *en bloc* value having been thus ascertained, an estimate of the number of units (tons, pounds, etc.) should be made. The *en bloc* value divided by the estimated number of units in the property will determine the per unit value, or amount of capital applicable to each unit, which, multiplied by the number of units mined and sold during any one year, will determine the sum which will constitute an allowable deduction from the gross income of that year on account of depletion.

Deductions computed on a like basis may be made from year to year during the ownership under which the value was determined, until the aggregate *en bloc* value as of March 1, 1913, of the mine or mineral deposits shall have been extinguished, after

which no further deduction on acount of depletion with respect to this property will be allowed to the individual or corporation under whose ownership the *en bloc* value was determined.

APPENDIX B

SUPPLEMENTARY DISCUSSION OF OPINION OF THE CIRCUIT COURT OF APPEALS

(*a*) The Circuit Court of Appeals held that the depletion rate determined by the Commissioner was not a correct rate because it did not represent the value in place of a ton of ore on March 1, 1913. In so holding, the court, relying entirely upon the Revenue Act of 1916, said (R. 162):

> Section 5 (Eighth-b) of the revenue act of 1916 (39 U. S. Stats. at L., p. 756, 759) provides that there shall be an allowance for depletion "not to exceed the market value in the mine of the product thereof, which has been mined and sold during the year for which the return and computation are made." This language, by its terms, has nothing to do with the whole body of the ore in place. It is not related to the market value of all of the tonnage in the mine, but the depletion relates to the market value in the mine of the product mined and sold during the year for which the return is made.

We submit that the Circuit Court of Appeals has misconstrued the section of the 1916 Act relied upon. The court seems to consider that the mar-

ket value in the mine of the product sold is the *necessary measure* of such allowance. We contend that the statutory provisions quoted in the above extract from the opinion are intended merely to prevent the deduction of a depletion allowance in excess of the income produced by the mine during the year with respect to which the depletion is claimed. This might occur in the case of one who operates a mine at a loss in a given year. It is not intended as the measure of depletion, for this Court has indicated in the *Ludey case, supra,* that the proper allowance under this Act is a *pro rata* part of the capital investment. That the language quoted is a limitation and not the measure of depletion is further evident from the construction given in *Lynch* v. *Alworth-Stephens Co.,* 267 U. S. 364, 369, *supra,* to the provision relating to corporate deductions:

> The general provision in section 12 (a), Second, is that the deduction from gross income shall include a reasonable allowance for the "exhaustion * * * of property." There is nothing to suggest that the word "property" is used in any restricted sense. In the case of mines, a specific kind of property, the exhaustion is described as depletion, and is limited to an amount not exceeding the market value in the mine of the product mined and sold during the year.

The conclusion of the Circuit Court of Appeals upon this point was reached without reference to the provisions of the Revenue Act of 1918, which governs one year involved in this case.

(*b*) The Circuit Court of Appeals assumed that the depletion allowance and March 1, 1913, value were determined by the Commissioner without reference to the interest which the quarterly payments would produce after their respective receipts. There is nothing in the record to justify such an assumption. Indeed it appears to be contrary to the facts, for the present value of $1 to be received at the end of 40 years, discounted at 6%, is 0.097222. Principles of Valuation, Grimes & Craigue, page 224.

Hence, it is perfectly apparent that the Commissioner did not, as the court's opinion states, proceed upon "the assumption that the *value* of the leases to plaintiff at the end of 40 years, will be $7,849,287.18." (R. 160.) This figure (which was not in his final computation) was the aggregate amount of the payments which she might expect under the leases—i. e. for 31,397,148.7 tons at 25 cents per ton, as appears from the figures in the tabulation immediately above this statement in the opinion.

(*c*) The "average extraction, 1913 to 1918," inclusive, is criticized by the court (R. 161) because, at the time this case was tried, it appeared that the extraction for 1917 and 1918 was vastly in excess of the earlier years. On March 1, 1913, the date as of which the value, and consequently the rate of extraction, must be determined, it would not have been possible to foresee and therefore to modify the lessees' extraction programs in the light of the demand created by the World War. The extraction program as well as the reserve is at best an estimate.

(*d*) The fact adverted to by the court (R. 161) that some leases had a shorter life than 40 years does not by any means show that the entire resources would be exhausted before that time. It could, for valuation purposes at least, make no possible difference to the lessor whether the royalties were paid in respect to one mine or another. The short-term leases were held by those who also held the long term, and it may well have been that the whole was to be extracted in 40 years at an average rate.

(*e*) The court says (R. 162):

> It can not be possible that the 1913 value can be fixed by the lease at .0886243 and at the same time have the lease yield to plaintiff 25 cents per ton for 1913 and every succeeding year of operation.

One who invests his capital to be repaid him in installments, over a long period, contemplates receiving each year income on his remaining investment, not merely on that part of his investment which he recovers in the year.

According to Hoskold's Table, the present value of $1 in accumulated earnings of equal annual installments over a period of 40 years on the basis of interest at 6% on the investment with a return of capital at 4%, is 0.354491. Saliers, Depreciation, Principles and Applications, pp. 467–468. On this basis 25 cents would have a present value of 0.08862+.

(*f*) The statement of the "Government's figures and processes" set forth in the opinion (R. 160) is taken from the taxpayer's Exhibit K. (R. 128.) But it is clear from the record that there were

later computations which gave different results and that Exhibit K does not show the manner in which the allowance was finally computed. The depletion allowance for 1917 is shown on Exhibit K as $92,194.92, but the certificate of overassessment for 1917 (Plaintiff's Exhibit M, R. 138–139) and the claim for refund for 1917 (Plaintiff's Exhibit R, R. 144–145) show that the final allowance for depletion was in fact $99,561.20. Likewise the allowance for 1918 was increased by the Commissioner, and instead of $77,968.20 (Plaintiff's Exhibit O, R. 141), $84,979.55 was finally allowed (Plaintiff's Exhibit P, R. 143).

APPENDIX C

EXTRACT FROM THE RECORD IN McHALE v. HULL

The following is an excerpt from the Agreed Statement of Facts (R. 48–49) in *McHale* v. *Hull*, No. 3780, in the Circuit Court of Appeals for the Seventh Circuit. This is the case referred to by the District Court (R. 44) and by the Circuit Court of Appeals (R. 159) in the instant case.

> The computation of the March 1, 1913, value of the plaintiff's royalty equity in each mine under each indenture was made by said Commissioner as follows:
>
> (1) The rate of royalty per ton was multiplied by the total estimated tonnage of ore to determine gross expected royalty income.
>
> (2) From gross expected royalty income a deduction of three per cent was made to determine net expected royalty income; as the said Commissioner has determined that the

average cost incurred by all lessors of iron mines in Minnesota for legal, engineering, accounting and other services, and for office expenses in connection with royalty collection amounts to approximately three per centum of the total royalties received.

(3) The March 1, 1913, value of the net expected royalty income was determined by multiplying the net expected royalty income by a discount factor. This discount factor was selected in accordance with the sinking fund method for valuing equal annual amounts of income. By this method the net expected royalty income (which said Commissioner assumed would be in equal annual amounts from March 1, 1913, to the end of the unexpired term under each indenture), pays simple interest of six per centum annually upon the March 1, 1913, value, so determined, and provides annually, in addition, a residuum of equal annual amounts which, if invested to accumulate at four per cent interest, compounded annually, would provide for the return of the March 1, 1913, value of the net expected royalty income under each indenture, at the expiration of the term of each indenture. The depletion rate per ton of ore for which royalty payment was received by the plaintiff in 1917 was computed by said Commissioner, by dividing the March 1, 1913, value of the net expected royalty income by the total estimated tonnage of ore in the mine subject to each indenture. The depletion deduction from gross income of $99,561.20, was

computed by said Commissioner as the sum of the amounts under each indenture determined by multiplying the several depletion rates per ton by the tonnages of ore for which royalty payment was received by the plaintiff during 1917, under the several indentures.

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